Castle Brands Inc
Form 10-Q
February 17, 2009

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended December 31, 2008
Commission File Number 001-32849
CASTLE BRANDS INC.
(Exact name of registrant as specified in its charter)

Delaware	**41-2103550**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
122 East 42nd Street, Suite 4700 **New York, New York**	**10168**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: (646) 356-0200

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

o Large accelerated filer	o Accelerated filer	o Non-accelerated filer (Do not check if a smaller reporting company)	þ Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

The Company had 101,033,764 shares of $0.01 par value common stock outstanding at February 17, 2009.

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PART I. FINANCIAL INFORMATION
Item 1. Condensed Consolidated Financial Statements

CASTLE BRANDS INC. AND SUBSIDIARIES
Condensed Consolidated Balance Sheets

	December 31, 2008 (Unaudited)	March 31, 2008
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 6,227,750	$ 1,552,385
Short-term investments	3,651,506	4,231,644
Accounts receivable net of allowance for doubtful accounts of $246,342 and $230,967	7,555,111	7,544,445
Due from affiliates	73,997	61,596
Inventories	8,090,330	8,535,993
Prepaid expenses and other current assets	786,523	811,711
TOTAL CURRENT ASSETS	26,385,217	22,737,774
EQUIPMENT net	643,254	753,317
OTHER ASSETS		
Intangible assets net of accumulated amortization of $3,050,762 and $2,517,199	13,057,570	13,591,191
Goodwill	3,745,287	3,745,287
Restricted cash	721,973	799,864
Other assets	147,659	509,493
TOTAL ASSETS	$ 44,700,960	$ 42,136,926
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
Current maturities of notes payable and capital lease	$ 2,044	$ 99,784
Accounts payable	4,082,848	2,818,910
Accrued expenses	2,549,251	2,142,845
Due to stockholders and affiliates	1,176,966	919,758
TOTAL CURRENT LIABILITIES	7,811,109	5,981,297
LONG-TERM LIABILITIES		
Senior notes payable		9,649,109
Notes payable and capital lease, less current maturities	300,000	9,001,335

Deferred tax liability		2,296,102		2,407,216
TOTAL LIABILITIES		10,407,211		27,038,957
COMMITMENTS AND CONTINGENCIES				
MINORITY INTERESTS		143,706		309,810
STOCKHOLDERS EQUITY				
Preferred stock, $.01 par value, 5,000,000 shares authorized, 2,391,311 and none issued and outstanding at December 31, and March 31, 2008, respectively		23,913		
Common stock, $.01 par value, 45,000,000 shares authorized; 15,629,776 shares issued and outstanding at December 31, and March 31, 2008, respectively		156,298		156,298
Additional paid-in capital		134,478,704		104,806,044
Accumulated deficiency		(100,220,195)		(87,546,011)
Accumulated other comprehensive loss		(288,677)		(2,628,172)
TOTAL STOCKHOLDERS EQUITY		34,150,043		14,788,159
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$	44,700,960	$	42,136,926

See accompanying notes to the condensed consolidated financial statements.

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CASTLE BRANDS INC. AND SUBSIDIARIES
Condensed Consolidated Statements of Operations
(Unaudited)

	Three months ended December 31, 2008	Three months ended December 31, 2007	Nine months ended December 31, 2008	Nine months ended December 31, 2007
Sales, net*	$ 6,912,185	$ 6,401,749	$ 20,234,680	$ 20,946,786
Cost of sales*	4,754,560	6,323,052	13,793,173	16,264,311
Gross profit	2,157,625	78,697	6,441,507	4,682,475
Selling expense	3,960,445	5,011,180	11,263,894	13,685,410
General and administrative expense	2,952,799	2,072,462	7,171,196	6,224,491
Depreciation and amortization	240,020	236,150	727,879	791,851
Loss from operations	(4,995,639)	(7,241,095)	(12,721,462)	(16,019,277)
Other income	31,590		56,974	
Other expense	(9,841)	(19,255)	(38,053)	(40,719)
Foreign exchange (loss) gain	(940,981)	144,454	(2,861,969)	1,304,389
Interest expense, net	(526,363)	(392,919)	(1,560,607)	(1,193,733)
Gain on exchange of 6% convertible subordinated notes	4,173,716		4,173,716	
Current credit on derivative financial instrument				189,397
Income tax benefit	37,038	37,038	111,114	111,114
Minority interests	(8,062)	613,877	166,103	1,105,267
Net loss	$ (2,238,542)	$ (6,857,900)	$ (12,674,184)	$ (14,543,562)
Net loss per common share, basic and diluted	$ (0.14)	$ (0.44)	$ (0.81)	$ (0.96)

Weighted average shares used in computation, basic and diluted	15,629,776	15,629,776	15,629,776	15,141,981

* Sales, net and Cost of sales include excise taxes of $1,068,649 and $896,035 for the three-months ended December 31, 2008 and 2007, respectively, and $3,173,839 and $5,197,091 for the nine-months ended December 31, 2008 and 2007, respectively.

See accompanying notes to the condensed consolidated financial statements.

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CASTLE BRANDS INC. AND SUBSIDIARIES
Condensed Consolidated Statements of Changes in Stockholders Equity
(Unaudited)

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Deficiency	Accumulated Other Comprehensive Loss	Total Stockholders Equity
BALANCE, MARCH 31, 2008		$	15,629,776	$ 156,298	$ 104,806,044	$ (87,546,011)	$ (2,628,172)	$ 14,788,159
Comprehensive loss:								
Net loss						(12,674,184)		(12,674,184)
Foreign currency translation adjustment							2,339,495	2,339,495
Total comprehensive loss								(10,334,689)
Issuance of Series A Preferred Stock, net of issuance costs	1,200,000	12,000			13,167,250			13,179,250
Exchange of 9% senior notes, including accrued interest	801,608	8,016			10,012,084			10,020,100
Exchange of 6% convertible subordinated notes, including accrued interest (net of gain on conversion of $4,173,716)	389,703	3,897			4,867,387			4,871,284
Stock-based compensation					1,625,939			1,625,939
BALANCE, DECEMBER 31, 2008	2,391,311	$ 23,913	15,629,776	$ 156,298	$ 134,478,704	$ (100,220,195)	$ (288,677)	$ 34,150,043

See accompanying notes to the condensed consolidated financial statements.

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CASTLE BRANDS INC. and SUBSIDIARIES
Condensed Consolidated Statements of Cash Flows
(Unaudited)

	Nine months ended December 31,	
	2008	**2007**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	$ (12,674,184)	$ (14,543,562)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	727,879	791,851
Provision for doubtful accounts	61,222	186,752
Minority interest in net loss of consolidated subsidiary	(166,103)	(1,105,267)
Loss on disposal of equipment		1,068
Amortization of deferred financing costs	474,493	484,369
Current credit on derivative financial instrument		(189,397)
Income tax benefit	(111,114)	(111,114)
Effect of changes in foreign exchange	2,651,764	(1,304,813)
Stock-based compensation expense	1,625,939	807,268
(Reversal of provision) provision for obsolete inventories	(252,241)	1,681,293
Non-cash interest charge	350,981	
Gain on exchange of 6% convertible subordinated notes	(4,173,716)	
Changes in operations, assets and liabilities:		
Increase in accounts receivable	(335,890)	(1,586,986)
Increase in due from affiliates	(13,719)	
Decrease (increase) in inventory	479,948	(883,438)
Decrease in prepaid expenses and supplies	14,905	62,239
Increase in other assets		(25,882)
Increase (decrease) in accounts payable and accrued expenses	2,342,323	(1,769,774)
Increase (decrease) in due to related parties	325,535	(219,366)
Total adjustments	4,002,206	(3,181,197)
NET CASH USED IN OPERATING ACTIVITIES	(8,671,978)	(17,724,759)
CASH FLOWS FROM INVESTING ACTIVITIES		
Acquisition of equipment	(111,881)	(236,614)
Acquisition of intangible assets	(21,536)	(20,219)
Short-term investments purchased	(3,650,000)	(10,000,000)
Short-term investments sold	4,230,138	8,741,090
Increase in other assets	(112,659)	
NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES	334,062	(1,515,743)

CASH FLOWS FROM FINANCING ACTIVITIES		
Notes payable net	(88,784)	(433,266)
Payments of obligations under capital lease	(3,164)	(2,745)
Increase in restricted cash	(8,613)	(179,800)
Issuance of common stock		21,014,609
Payments for costs of common stock issuance		(1,396,123)
Proceeds from promissory note	2,000,000	
Issuance of Series A Preferred Stock	13,000,000	
Payments for costs of Series A Preferred Stock issuance	(1,820,750)	
NET CASH PROVIDED BY FINANCING ACTIVITIES	13,078,689	19,002,675
EFFECTS OF FOREIGN CURRENCY TRANSLATION	(65,408)	23,933
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	4,675,365	(213,894)
CASH AND CASH EQUIVALENTS BEGINNING OF PERIOD	1,552,385	1,004,957
CASH AND CASH EQUIVALENTS END OF PERIOD	**$ 6,227,750**	**$ 791,063**

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CASTLE BRANDS INC. and SUBSIDIARIES
Condensed Consolidated Statements of Cash Flows
(Unaudited)
(Continued)

	Nine months ended December 31,	
	2008	**2007**
SUPPLEMENTAL DISCLOSURES		
Exchange of 9% senior notes, including all accrued interest, by issuance of Series A Preferred Stock	$ 10,020,100	$
Exchange of 6% convertible subordinated notes, including all accrued interest, by issuance of Series A Preferred Stock	$ 9,045,000	$
Conversion of promissory note	$ 2,002,778	$
Interest paid	$ 1,307,163	$ 730,254

See accompanying notes to the condensed consolidated financial statements.

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CASTLE BRANDS INC. AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements
Unaudited

NOTE 1 GOING CONCERN

The accompanying condensed consolidated financial statements have been prepared assuming that Castle Brands Inc. (the Company) will continue as a going concern. The Company has incurred significant operating losses and has not generated positive cash flows from its operating activities since inception. For the three and nine-months ended December 31, 2008, the Company had a net loss of $2,238,542 and $12,674,184, respectively, and used cash of $4,277,648 and $8,921,978, respectively, in operating activities. As of December 31, 2008, the Company had an accumulated deficiency of $100,220,195. In addition, the Company was previously obligated to pay $10,000,000 in principal pertaining to senior notes maturing in May 2009. These conditions raise substantial doubt about the Company s ability to continue as a going concern. The report of the Company s Independent Registered Public Accounting Firm contained in the Company s Annual Report on Form 10-K, as amended, for the year ended March 31, 2008 (2008 Form 10-K), filed with the Securities and Exchange Commission (SEC), also contained an explanatory paragraph referring to an uncertainty concerning its ability to continue as a going concern.

The Company is continuing to implement a plan supporting the continued growth of existing brands through a variety of sales and marketing initiatives that the Company expects will generate cash flows from operations. As part of this plan, the Company intends to grow its business through continued expansion to new markets and within existing markets, as well as strengthening distributor relationships. The Company is also seeking additional brands and agency relationships to leverage the existing distribution platform, as well as a systematic approach to expense reduction, improvements in routes to market and production cost containment to improve existing cash flow.

As further described in Note 9 herein, on October 20, 2008, the Company completed a private placement of $15,000,000 of its Series A Convertible Preferred Stock (Series A Preferred Stock). The Company incurred approximately $1,800,000 in expenses associated with this transaction. In connection with the transaction, substantially all of the holders of Castle Brands (USA) Corp. s (CB-USA) 9% senior secured notes, in the principal amount of $9,700,000 plus accrued but unpaid interest, and all holders of the Company s 6% convertible subordinated notes, in the principal amount of $9,000,000 plus accrued but unpaid interest, converted their notes into shares of Series A Preferred Stock. Management anticipates that the closing of the cash investment and the conversion of substantially all of the outstanding debt provide the Company with sufficient funds to execute its planned operations for at least the next twelve months.

NOTE 2 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying condensed consolidated financial statements do not include all of the information and footnote disclosures normally included in financial statements prepared in accordance with the rules and regulations of the SEC and U.S. generally accepted accounting principles (GAAP) and, in the opinion of management, contain all adjustments (which consist of only normal recurring adjustments) necessary for a fair presentation of such financial information. Results of operations for interim periods are not necessarily indicative of those to be achieved for full fiscal years. The condensed consolidated balance sheet as of March 31, 2008 is derived from the March 31, 2008 audited financial statements. These condensed consolidated financial statements should be read in conjunction with the Company s audited consolidated financial statements for the fiscal year ended March 31, 2008 included in the 2008 Form 10-K. Please refer to the notes to the audited consolidated financial statements included in the 2008 Form 10-K for additional disclosures and a description of accounting policies.

A. Description of business and business combination The condensed consolidated financial statements include the accounts of the Company, its wholly-owned subsidiaries, CB-USA and McLain & Kyne, Ltd. (McLain & Kyne), and its wholly-owned foreign subsidiaries, Castle Brands Spirits Group Limited (CB-IRL) and Castle Brands Spirits Marketing and Sales Company Limited (CB-UK), and its 60% ownership interest in Gosling-Castle Partners, Inc. (GCP), with adjustments for income or loss allocated based upon percentage of ownership. The accounts of the subsidiaries have been included as of the date of acquisition. All significant intercompany transactions and balances have been eliminated.

As used herein, the Company refers to Castle Brands Inc. and, where appropriate, it also refers collectively

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CASTLE BRANDS INC. AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
Unaudited

to Castle Brands Inc. and its direct and indirect subsidiaries, including its majority owned GCP subsidiary.

B. Organization and operations The Company is principally engaged in the importation, marketing and sale of fine spirit brands of vodka, whiskey, rums and liqueurs in the United States, Canada, Europe, Latin America and the Caribbean. Except for Gosling s rums and the bourbon products, which are bottled in the United States, all of the Company s products are imported from Europe. The vodka, Irish whiskeys and certain liqueurs are procured by CB-IRL, billed in Euros and imported into the United States. The risk of fluctuations in foreign currency is borne by the U.S. entities.

C. Goodwill and other intangible assets Goodwill represents the excess of purchase price including related costs over the value assigned to the net tangible and identifiable intangible assets of businesses acquired. As of December 31, 2008 and March 31, 2008, goodwill and other indefinite lived intangible assets that arose from acquisitions were $3,745,287. Goodwill and other identifiable intangible assets with indefinite lives are not amortized, but instead are tested for impairment annually, or more frequently if circumstances indicate a possible impairment may exist. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to the estimated residual values and reviewed for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable.

Under SFAS No. 142, Goodwill and Other Intangible Assets (SFAS 142), impairment of goodwill must be tested at least annually by comparing the fair values of the applicable reporting units with the carrying amount of their net assets, including goodwill. If the carrying amount of the reporting unit s net assets exceeds the unit s fair value, an impairment loss would be recognized in an amount equal to the excess of the carrying amount of goodwill over its implied fair value. The implied fair value of goodwill is determined in the same manner as the amount of goodwill recognized in a business combination with the fair value of the reporting unit deemed to be the purchase price paid.

The fair value of each reporting unit was determined at March 31, 2008 by weighting a combination of the present value of the Company s discounted anticipated future operating cash flows and values based on market multiples of revenue and earnings before interest, taxes, depreciation and amortization (EBITDA) of comparable companies. Such valuations resulted in the Company recording a goodwill impairment loss of $8,750,000 for the year ended March 31, 2008. Such adjustments were attributable to downward revisions of earnings forecasted for future years, an increase in the incremental borrowing rate due to operating results that were worse than anticipated and an overall decrease in the value of the comparable companies.

D. Impairment of long-lived assets In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets , the Company periodically reviews whether changes have occurred that would require revisions to the carrying amounts of its long-lived assets. When the sum of the expected future cash flows is less than the carrying amount of the asset, an impairment loss is recognized based on the fair value of the asset. The Company concluded that there was no impairment during the three and nine-months ended December 31, 2008.

E. Excise taxes and duty Excise taxes and duty are computed at standard rates based on alcohol proof per gallon/liter and are paid after finished goods are imported into the United States and Great Britain, are tax paid and then transferred out of bond. Excise taxes and duty are recorded to inventory as a component of the cost of the underlying finished goods. When the underlying products are sold ex warehouse the sales price reflects the taxes paid and the inventoried excise taxes and duties are charged to cost of sales. Historically, the Company s sales in Ireland have been made in-bond , net of excise taxes. In September 2007, the Company made an initial sale to its new distributor in Ireland ex-bond that included $1,861,995 million in excise taxes and VAT. These taxes are reflected in both the Company s revenues and cost of sales as an equal increase to both.

F. Foreign currency The functional currency for the Company s foreign operations is the Euro in Ireland, and the British Pound in the United Kingdom. The translation from the applicable foreign currencies to U.S. Dollars is performed for balance sheet accounts using exchange rates in effect at the balance sheet date and for revenue and expense accounts using a weighted average exchange rate during the period. The resulting translation adjustments are recorded as a component of other comprehensive income. Gains or losses resulting from foreign currency transactions are shown as a separate line item in accompanying condensed consolidated statements of operations. The Company s vodka, Irish whiskeys and certain liqueurs are

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CASTLE BRANDS INC. AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
Unaudited

procured by CB-IRL and billed in Euros to the U.S. entities, with the risk of foreign exchange gain or loss resting with CB-USA. In addition, the Company has funded the continuing operations of the international subsidiaries. At each balance sheet date, the Euro denominated intercompany balances included on the books of CB-IRL are restated in U.S. Dollars at the exchange rate in effect at the balance sheet date, with the resulting foreign currency transaction gain or loss included in net loss.